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ABSTRACT

Written for secondary school Canadian students, the document examines Canada's international trade policy. It is arranged in three sections. Part I discusses the affect of Canada's trade policy on the individual citizen. Tariffs and non-tariff barriers to trade such as import licenses, preferential purchasing agreements, health and safety standards, and subsidies are explored. The section also outlines the history of the Canadian tariff in relation to the United States tariff since 1869 and notes the effects of the 1974 General Agreement on Tariffs and Trade (GATT). Tables present rates of tariffs on primary and manufactured goods, percentages of exports of goods-producing industries, and percentages of Canada's merchandise trade by country and by commodity: farm and fishery, crude materials, fabricated materials, and manufactured products. An analysis of changing demand for exports concludes the chatter. Part II examines trade patterns and Canada's comparative advantage in world trade, and focuses on factors which interfere with free trade including trade barriers, national policies, and the desire for security. Part III explains why Canada's small market cannot support a large number of producers and product lines at world competitive prices. Costs and benefits of two approaches are examined: trade liberalization and domestic measures. The reorganization of industry; the effects of free trade on employment and industrial efficiency; and economic, political, and social considerations; and possible routes to free trade are analyzed. (KC)

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Understanding Canada's International Trade Policy

Peter M. Cornell

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This booklet on Understanding Canada's International Trade Policy is the fourth of a series on Understanding Economics.

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The Canadian Foundation for
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Preface

International trade policy is a most controversial economic issue. Canada's trade policy has been a determinant part of her economic and political history since Confederation.

Three factors give trade policy particular significance to Canada; we are a vast country with a small population; our natural resource endowment is enviable and envied; and we live next door to the world's economic giant. These three influences have always meant that if a "hands-off" trade policy were adopted, Canada would export – almost exclusively – raw materials for other countries to process; and that we would import all the manufactured goods we need.

But this "hewers of wood and drawers of water" scenario has never been an acceptable one, and Canada has used tariff and non-tariff barriers to foster its own industries.

The international atmosphere – rhetorically at least – for trade restrictions has become less tolerant over the past 25 years. As a participant in trade negotiations that have greatly expanded world trade flows, Canada has made concessions that have significantly reduced the protection afforded its manufacturing industries, and at present is being called upon to enter into further reductions in the current round of GATT negotiations.

The economic theory in support of free trade is elegantly convincing, and economists have argued it long and hard over the years. But the removal of protection itself is quite a bit less appealing. Negotiators may accept that all parties can benefit from international specialization and trade, but they are more highly motivated by a desire to ensure that voters back home aren't injured. And not all countries measure benefits according to the same yardstick – because not all countries are in pursuit of the same trade goals.

The material presented herein represents an economist's overview of this very complex subject. Dr. Peter Cornell, the author, was very deeply involved in a major research project conducted by the Economic Council of Canada, the object of which was to examine Canada's trade options. He is one of Canada's most authoritative voices on the subject of trade.

The main point to remember when reading this study is that the complexity and multiplicity of factors involved make final and conclusive statements nearly impossible: reality is constantly changing and trade-offs based on one year's priorities may be obsolete the following year.

J.H.

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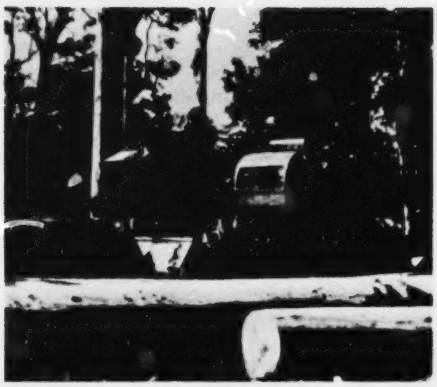

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The Canadian textile industry would face much stiffer competition if multilateral free trade were introduced in Canada. Textiles are often produced in less developed countries using the same technology as is used in North America, but lower labour costs allow for lower selling prices.

photo: Courtesy Dominion Textile Limited

Part I: What's the Problem?

Commercial Policy and You

Have you baught a pair of skis lately? A bicycle? Running shoes? a shirt? A radio? If you have, you were directly affected by Canada's international trade policy, or, as it is often referred to, commercial policy.

If a Canadian industry cannot produce a particular product as cheaply as one that can be imported, the government may place a tariff – really a tax – on the foreign-made good. This raises its prices to a point where the Canadian producer can compete. For example, because of our tariff, a pair of skis that might sell for $100 in Austria where they are made would probably be priced at $125 (plus transportation costs) in Canada. Thus if a Canadian ski manufacturer could produce and sell a similar product for, say, $120 or $125, he could still remain in business.

Tariffs are only one of a number of commercial policy measures that governments may use to limit the amount and type of goods that we buy from other countries. Non-tariff barriers to trade are also widely used. Their aim is often the same: to increase and diversify industrial activity and to create, or at least maintain jobs where they would not otherwise exist.

Non-tariff Barriers to Trade

As tariff levels declined in recent years, non-tariff barriers to trade have become relatively more important. These barriers include:

Licences to import (or export) particular goods.

Quotas. For example, the government might say that only 200,000 shirts could be imported into Canada in a particular year.

Preferential purchasing arrangements. A government might say, for example, that it will buy only electrical generators made by domestic manufacturers, or more commonly, that it will purchase such items from foreigners only if their price is some percentage – say 15 per cent – below the price quoted by domestic producers.

Health and safety standards; e.g. Canada disallows the importation of flammable toys.

Subsidies. Governments may provide financial assistance to business for the production or export of particular goods. This can be done by direct payments of money or perhaps by tax rebates.

Canada has long used trade measures for these purposes. Although our tariffs have come down a lot in recent years, some of our industries are still highly protected and even more stringent quotas have recently been introduced on textiles and clothing, electrical appliances, and chemicals. The possibility of further reductions in the protection of our own and foreign industries is being actively discussed at this time, partly because Canada is again participating in an extensive round of trade negotiations in Geneva in 1977 and 1978.

More important, a number of features of the Canadian economy and of the international economy are changing. These changes are forcing us to make some very basic decisions that would affect the shape of our economy and the structure of our industry for many years. We must assess the benefits and costs of trade barriers – or the absence of trade barriers – in the light of these changing circumstances.

One Hundred Years of Protection

For real heat, and for the record as the longest, most drawn-out and bitter argument in this country, the one about commercial policy is hard to beat.

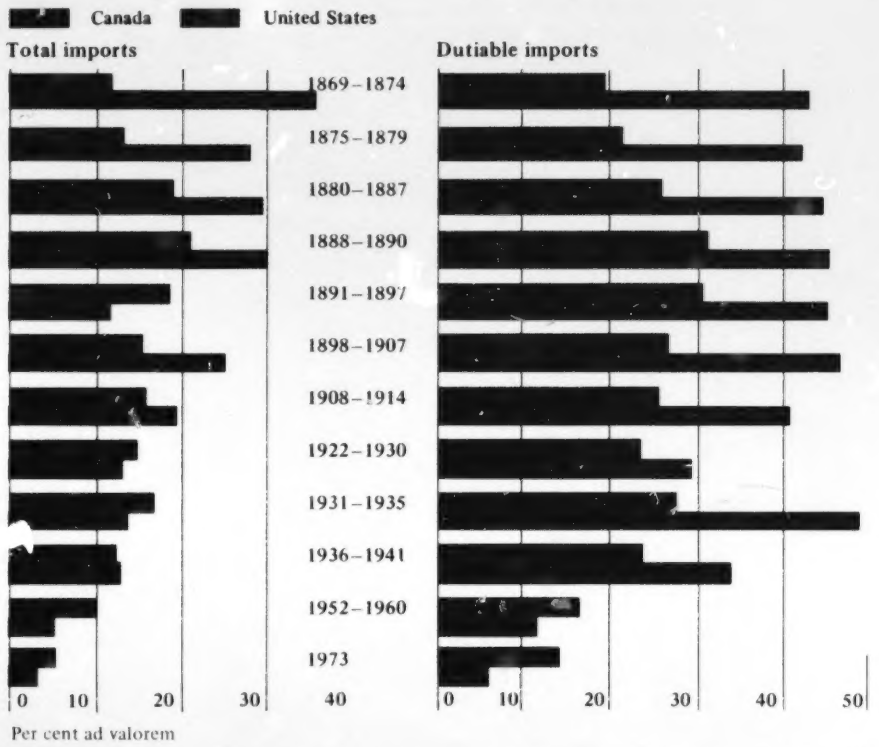
The reasons are not hard to find. The effects of tariffs, for example, have differed both among our various provinces and regions and among particular groups and industries. Moreover, commercial policy has always been linked closely in Canada with political objectives, notably independence and national unity; it cannot be judged only in economic terms.

Figure 1 sums up the history of the Canadian tariff in relation to the U.S. tariff. Changes in our tariff have been strongly influenced by events in the United States. Prior to Confederation there was a twelve-year period of free trade (that is, no trade barriers) between Canada and the United States, and many Canadians liked the arrangement. But even before the United States ended the Reciprocity Treaty in 1866, the Congress was chilling to the idea. By the mid-1860s, it was becoming clear that the British North American provinces would have to look to their own union for economic and political strength.

Events in the decade following Confederation confirmed this feeling. The United States, with its industry greatly expanded by the Civil War, was pushing westward rapidly – a push that brought even the threat of actual invasion of Canadian territory. To strengthen Canadian unity and independence in the face of this pressure, the Concervative government of Sir John A. MacDonald adopted the National Policy in 1879. This started as a program of high tariffs, designed to promote the develop-

Figure 1

Average Nominal Rates of Duty, Canada and United States, 1869 – 1973



Source: Economic Council of Canada, Looking Outward: A New Trade Strategy for Canada (Ottawa: Information Canada, 1975), p.4. Based on H.M. Pinchin, "The Regional Impact of the Canadian Tariff", a background study for the Economic Council of Canada.

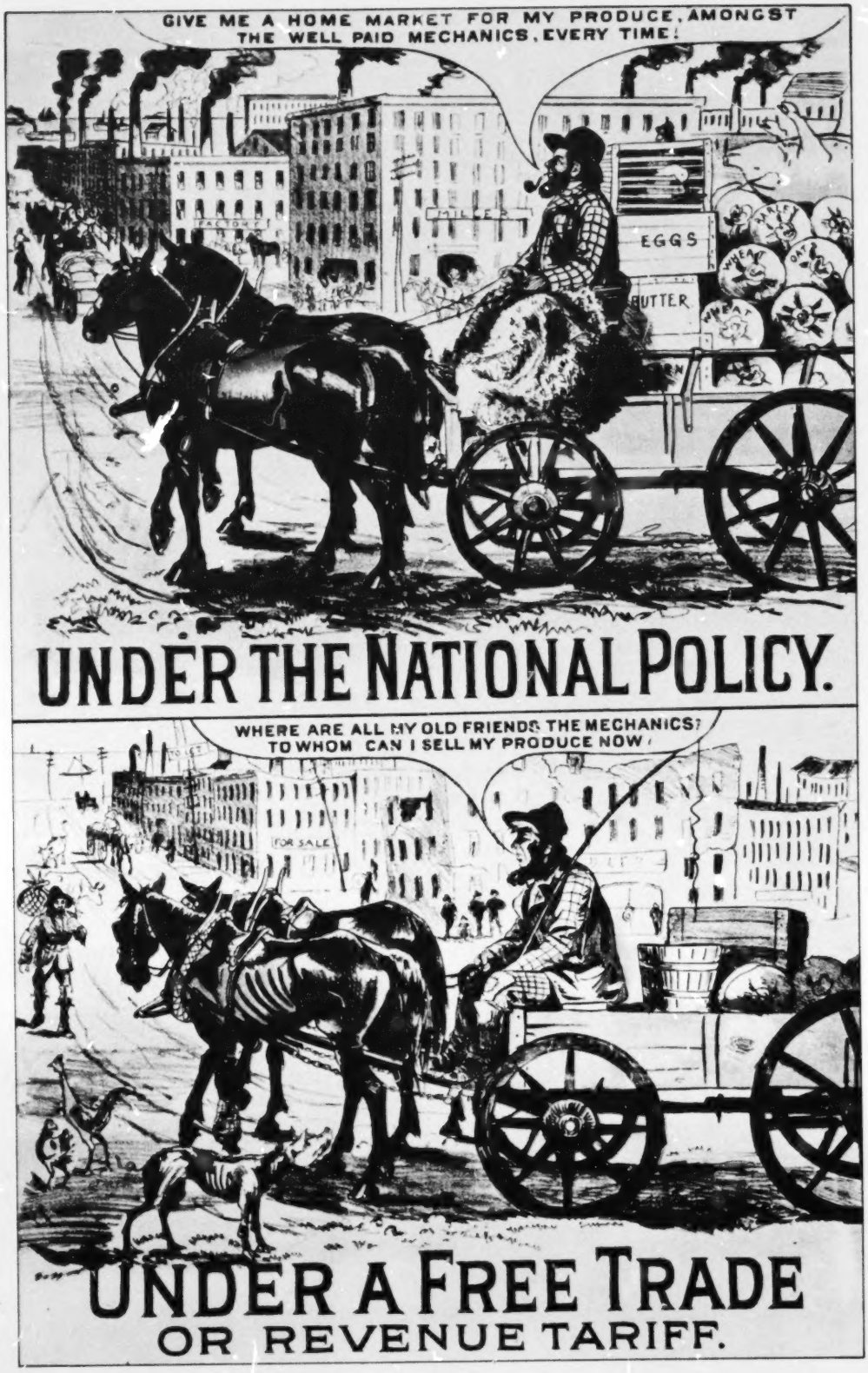
ment of manufacturing, particularly in central Canada, and soon included immigration and transportation policies to stimulate the growth of population and natural resource-based industries in the west. The idea was that more trade within Canada and between Canada and Europe would offset the growing influence of the United States.

The emphasis on east-west rather than north-south (or continental) trade has been questioned even since 1879. Frequently, the most bitter criticisms came from the Maritime and western provinces who saw themselves paying for the industrialization of central Canada. Protection was favoured, however, by a combination of economic interests, largely in Ontario and Quebec, and by those who saw the tariff wall as a way of maintaining independence from the United States. Here are some of the highlights of our commercial policy history:

1891 The Liberals went down to defeat in a general election on a policy of Canada–U.S. free trade. The Conservatives said free trade would lead to the United States taking over this country.

1911 Another general election with more flagwaving, accusations of disloyalty and a new slogan in Canada: "No truck nor trade with the Yankees." Another Liberal government which supported free trade with the United States, that of Sir Wilfrid Laurier, was defeated.

1930s Canada's tariffs, along with those of many other countries, and particularly those


GIVE ME A HOME MARKET FOR MY PRODUCE, AMONGST THE WELL PAID MECHANICS, EVERY TIME!
EGGS
BUTTER
WHEAT
UNDER THE NATIONAL POLICY.
WHERE ARE ALL MY OLD FRIENDS THE MECHANICS? TO WHOM CAN I SELL MY PRODUCE NOW?
FOR SALE
UNDER A FREE TRADE
OR REVENUE TARIFF.

Cartoon from the MacDonald Papers, courtesy of the Public Archives of Canada, Ottawa

of the United States, were raised even higher. During the Great Depression, everyone tried to maintain employment by protecting their own industries. Canada was also instrumental in further developing a system introduced earlier – preferential tariffs among countries of the British Commonwealth at rates lower than those extended to non-Commonwealth nations. Canada also negotiated its first trade agreement with the United States since 1866.

1947 Canada and many other countries* signed the General Agreement on Tariffs and Trade (GATT).

1948 to 1966 Six separate rounds of negotiations to reduce tariffs were held under the GATT.

1977 A further round of GATT negotiations scheduled to continue into 1978.

The signing of GATT in 1947 was an important turning point for Canadian commercial policy. In the 1930s, many countries used protection to promote employment – referred to as "beggar-my-neighbour" policies – and to try to become more self-sufficient. As a result, international trade declined greatly and everyone lost out.

To prevent a recurrence the signing countries agreed that commercial policy measures should be aimed at increasing, not reducing, world trade. They wanted to avoid the use of trade barriers as a device to promote jobs in domestic industries. Other methods, such as fiscal policy, should be used to keep employment high while trade increased. They agreed too that GATT negotiations would be based on the unconditional most-favoured-nation principle. That principle means that if a country gives a tariff concession to one other member, the concession must be given to all other members. Canadians had long searched for ways of offsetting U.S. influence. Bargaining, not with the United States alone but with a much larger group of countries (multilateral negotiations), seemed like a good idea to Canada.

Despite Canada's strong support for the multilateral approach, however, the Canadian economy has become much more integrated with that of the United States since the end of the Second World War. Partly this has been the result of world economic conditions. For example, Canada was for many years considered to be the most stable and attractive place for U.S. investment. But integration has been reinforced also by formal agreements between the two countries such as those on defence production sharing and on the automotive industry. In recent years, however, this growing interdependence has become a matter of increasing political concern in Canada.

Twenty-three countries, including Canada, the United States, the United Kingdom, France, India, Pakistan, Brazil, Chile, Australia, New Zealand, South Africa, Belgium and the Netherlands originally signed the Agreement. As of December 1972, there were 81 full members and 16 countries participating under other arrangements.

Trade Barriers, Trade Patterns and Industrial Structure

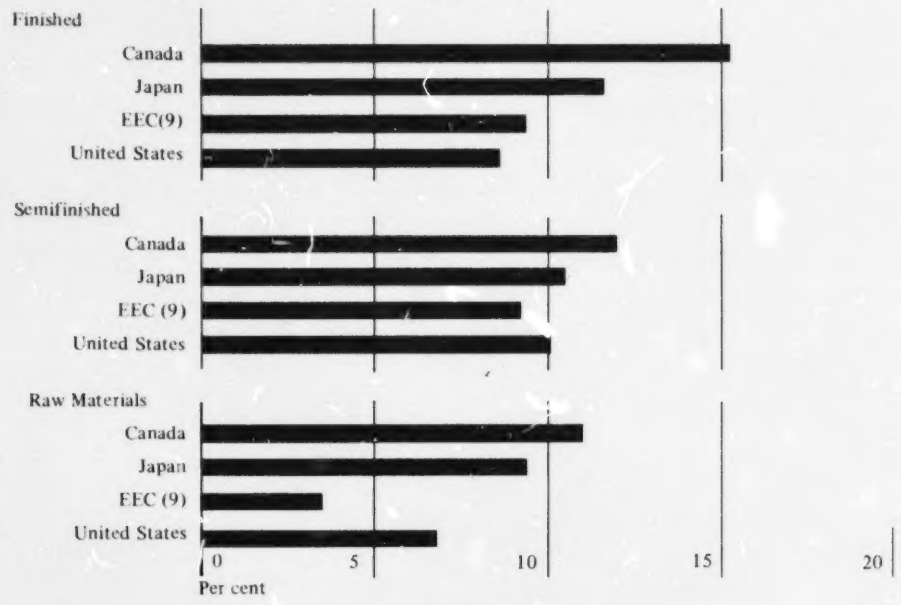
Where are we now? Figure 1 shows that Canada's tariffs have, on average, come down a great deal, particularly in recent years. Despite these cuts, other countries are quick to point out that our tariffs are still somewhat higher, on average, than those of the major countries with whom we trade (Figure 2). On the other hand, Canadian exporters face extensive nontariff barriers in other countries – in many cases, more extensive than our own (Figure 3).

The tariffs that Canada applies differ among various classes of goods (Figure 2). Slightly more than half of the goods we import come into the country duty-free. These include most raw materials, but also such things as new cars manufactured in the United States, and books that are used in school curricula. Partly processed goods, such as copper rods used in the manufacture of electric wire, can enter under relatively low tariffs in the 5 to 10 per cent range. Finished manufactured products are usually subject to higher tariffs. The items mentioned earlier – skis, running shoes, radios, bicycles and shirts – carry tariffs of 15 to 25 per cent and shirts, for example, are also subject to quotas.

The goods that Canada exports face similar tariff schedules in the other countries (Figure 2). Consequently, although it may not be too dificult to sell something that has not been processed much (such as nickel ingots), advanced manufactures (e.g., electrical equipment) are something else again.

Figure 2

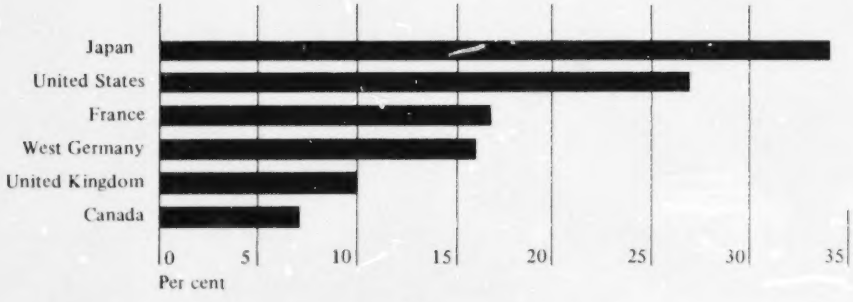
Most-Favoured-Nation Tariff Rates on Dutiable Imports, 1973



Source: Economic Council of Canada, Looking Outward: A New Trade Strategy for Canada (Ottawa: Information Canada, 1975), p. 13. Based on General Agreement on Tariffs and Trade, Basic Documentation for the Tariff Study (Geneva: GATT, 1974).

Figure 3

Proportion of Commodity Import Groups Subject to Non-tariff Trade Barriers, Selected Countries 1967



It is only fair to add that Japan, which appears in the least favourable light on the basis of past data, has since 1967 substantially reduced the number of NTBs applied.

Source: Economic Council of Canada, Looking Outward: A New Trade Strategy for Canada (Ottawa: Information Canada, 1975), p. 16. Based on Ingo Walter, "Non-Tariff Protection Among Industrial Countries: Some Preliminary Evidence", Economia Internazionale 25, no. 2, (May 1972): 350.

TABLE

Nominal Rates of Protection for Canadian Industries, by Major Group, 1970

	Nominal Tariffs
	(Per cent)
Primary	
Agriculture	2.05
Forestry	0.01
Fishing and trapping	0.61
Mining, quarrying, and oil wells	0.19
Manufacturing	
Food and beverages (excluding alcohol)	7.96
Rubber	14.36
Leather	19.23
Textiles	17.00
Knitting mills	23.08
Clothing	21.46
Wood	4.59
Furniture and fixtures	15.54
Paper and allied products	6.09
Printing and publishing	6.89
Primary metals	2.84
Metal fabricating	11.27
Machinery	5.36
Transportation equipment	3.04
Electrical products	12.43
Non-metallic mineral products	6.24
Petroleum and coal products	7.90
Chemical and chemical products	8.34
Miscellaneous	10.76

Source: Economic Council of Canada, Looking Outward: A New Trade Strategy for Canada (Ottawa: Information Canada, 1975), p. 14. Based on Bruce W. Wilkinson and Ken Norrie, Effective Protection and the Return to Capital (Ottawa: Information Canada, 1975).

Protection also varies greatly among our various industries (Table 1). For the primary industries, which produce raw or at best semi-processed materials, it is very low. On the other hand, it is generally high in secondary industries such as textiles and clothing that tend to use a lot of labour.

Trade barriers, whether our own or foreign, are not the only influences on the pattern of our international trade or on the structure of our industry. But just what has developed under the systems of protection existing here and in other countries? These are some of the main characteristics of our trade:

Trade is very important to this country. Roughly one quarter of everything we produce (Gross National Product) is exported. We import about the same proportion. For the goods-producing industries (defined to include agriculture, fishing, forestry, trapping, mining, manufacturing, construction and utilities) trade is even more important. Half their production is exported (Figure 4) and we also import the equivalent of half of that production.

But our trade is lopsided, both geographically and with respect to its commodity composition (Figures 5 and 6). Roughly 70 per cent of our trade (both exports and imports) is with the United States alone. We also import far more highly manufactured goods than we export. In fact, if automotive products, which are a special case under the Canada – U.S. Automotive Agreement, are excluded, highly manufactured products now account for about one-half our imports and less than one-sixth of our exports (Figure 6). In terms of the productive factors that go into the goods we trade, Canada, on balance, is exchanging natural resources and the services of unskilled or semi-skilled labour for the services of highly-skilled labour from other countries.

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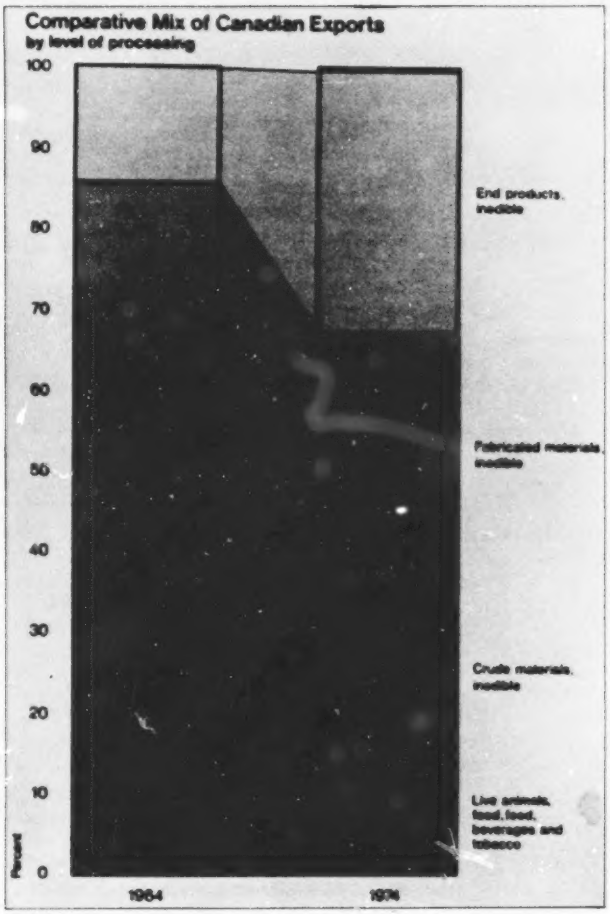


Since the early 1960s, Canada has become increasingly interested in exporting our natural resources in more highly processed form, e.g. as copper tubing rather than as copper ore. In this way, we increase the value of our exports in world markets and create more jobs in Canada.

Certain features of the structure and operation of our industry are also worth noting:

Manufacturing, the sector of the economy most affected by trade barriers, includes a broad range of industries that now account for about one-fifth of total employment in Canada. That proportion has been declining slowly for some years.

The efficiency or "productivity" of our manufacturing sector, as measured by output per man-hour, has been increasing more or less steadily for many years. Despite this increase, the level of output per man-hour in manufacturing is still 15 to 20 per cent lower in Canada than in the United States*. Moreover, in recent years, the level of output per man-hour in Japanese manufacturing has also moved above the Canadian figure.

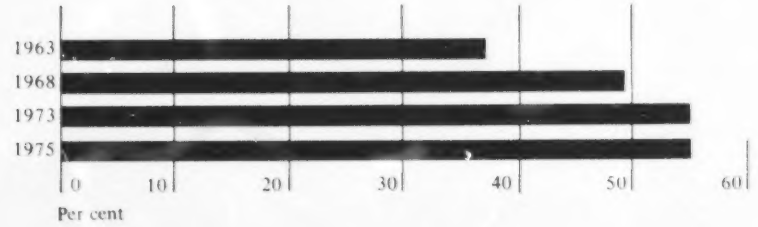
Canadian manufacturing plants tend to be smaller than their foreign counterparts in the same industry. More important, even where they are the same size or larger than, say, American plants, they tend to be far less specialized, i.e., they produce more product lines**.

**These statistics disguise major productivity differences in different manufacturing industries, because there are averages for manufacturing as a whole. In fact, some Canadian industries are as efficient as those in the U.S.*

*** See "Understanding Productivity" by Libby Joyce; a CFEE publication.*

Figure 4

Exports of Goods as a Percentage of the Output of Goods-Producing Industries,[1] Selected Years

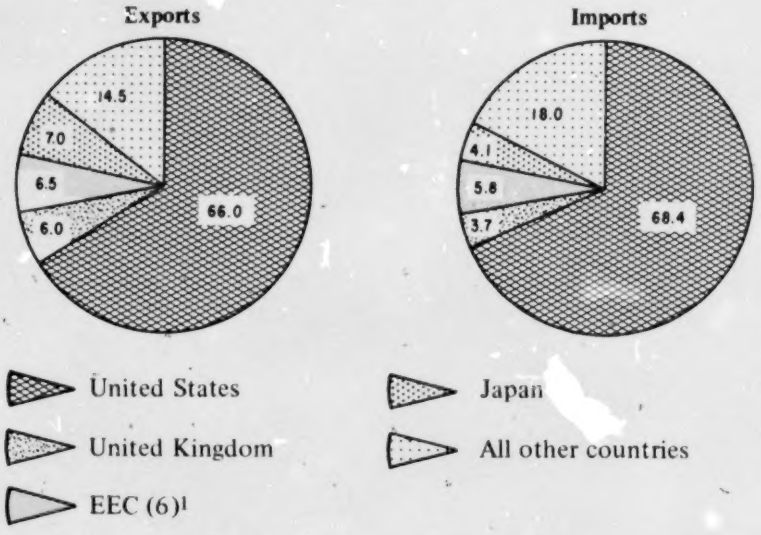


1 Goods-producing industries include agriculture, fishing, forestry, trapping, mining, manufacturing, construction, and utilities.

Source: Based on Data from Statistics Canada.

Figure 5

Area Distribution of Canada's Merchandise Trade
Average 1973-75

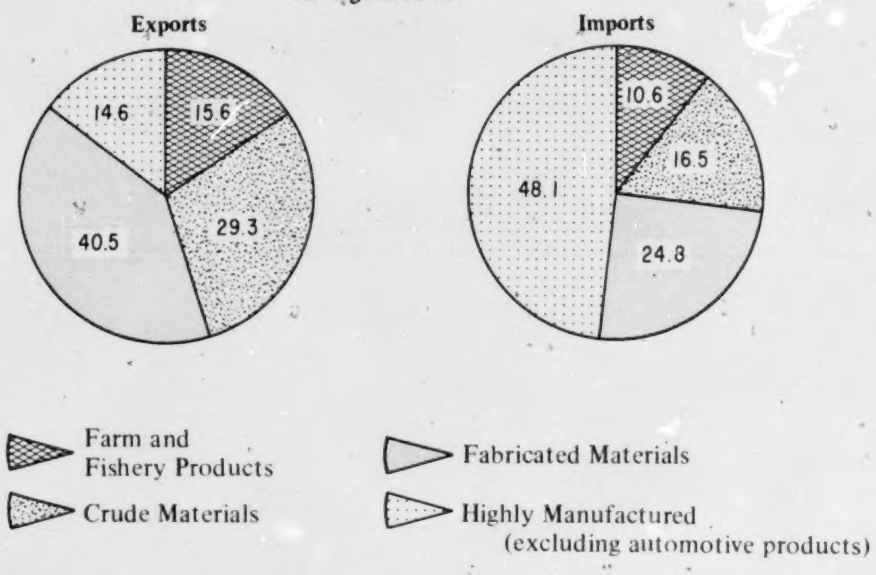


[1] France, West Germany, Italy, Belgium, Netherlands, Luxembourg.

Source: Based on data from Statistics Canada.

Figure 6

Percentage Distribution of Canada's Total Merchandise Trade
(Excluding Automotive Products) by Major Commodity Group
Average 1973-75



Source: Based on data from Statistics Canada.

Your World

History provides some useful insights into the problems surrounding decisions about Canadian commercial policy. But the decisions facing us today do not concern the policy that is appropriate for 1977 or 1978 but the 1980s and beyond – *your* world.

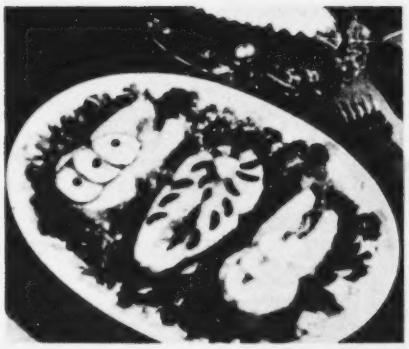
Your world will be considerably different from that of the 1960s or early 1970s, let alone the 1870s when our protective policy was originally conceived. And it is changing very rapidly. In fact, the ability to adapt quickly to change might well be considered one of the most important requirements of a modern economy.

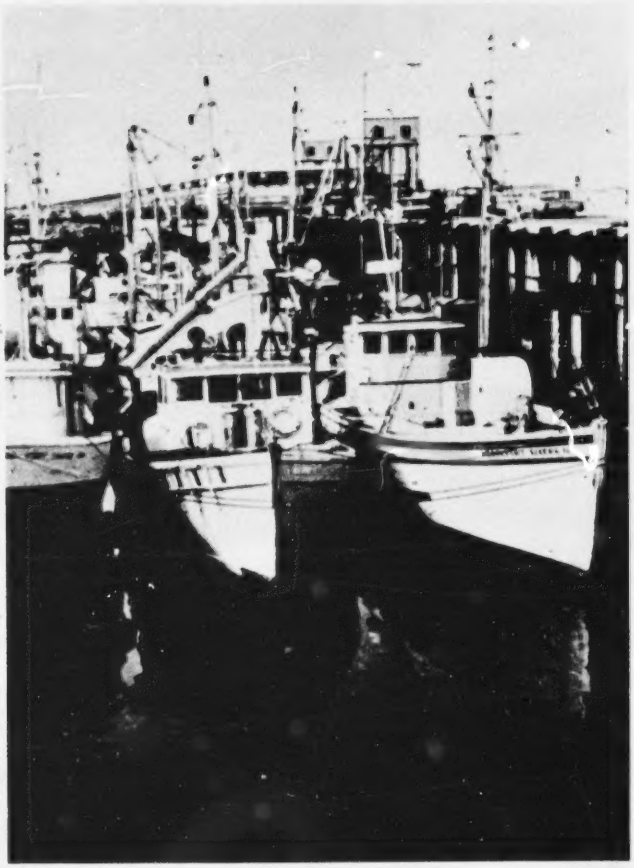
Even fifteen years ago, Canada's home market was not much below the average size for industrial countries in terms of population. By 1980 it will be less than one-quarter of the average. Some of the major countries with which we trade, such as the United States and Japan, themselves have populations in the hundreds of millions. Others, like members of the European community, have grouped together in very large economic blocs. They are much better able than we to produce at lower cost through mass production.

Canada will also face increasing competition from developing nations. Korea, the Philippines, Brazil or Mexico, for example, used to be thought of mainly as producers of

Canada imports some Italian wine by the 10 gallon demijohn. Here, the flagons are loaded in Toronto Harbour to be returned to Italy for a refill.

photo: Courtesy of the Toronto Harbour Commission





Canada has incredible wealth in her natural resources and the potential to turn a much larger proportion of them into finished or semi-finished products for export.

food, raw materials, or relatively simple manufactured goods like textiles or shoes. Now they are making automobiles, television sets, and machine tools. For many such items, whose production is based on technology that is more or less standard everywhere, producers in highly developed nations often cannot match the manufacturing costs of competitors in the developing countries.

Developing nations are also pressing very hard now for a "New International Economic Order". They want affairs rearranged in such a way that they will share more in the world's economic progress. To achieve this, they must be able to sell their products more easily in the industrial countries, including Canada. The Canadian government, and many individual Canadians, have expressed sympathy for the aims of this new order. This is not simply a matter of charity. Later on (pp. 14-20) we will show how both Canada and the developing countries can gain from specializing in the production of goods that each produces most efficiently. But, increasing imports from these countries could mean fewer jobs for Canadians in some of our present industries. To help them, without suffering very adverse consequences ourselves, we would have to shift our production more into goods in which we have advantages that the developing countries lack. This would not be easy unless Canadian producers could in turn get better access to the markets of the other industrial nations. We're caught in a squeeze.

There are changes *inside* Canada too that will affect our thinking about future commercial policy. One of the reasons we have lived so well compared with other countries is that we've been able to sell our abundant natural resources in world markets. However, some of these – mining or petroleum products for instance – cannot be replaced. And it is just these irreplaceable resources that we have sold in increasing quantities in recent years.

This cannot go on forever. In the case of petroleum it has already been sharply reversed. Not surprisingly, the Government of Alberta, our chief oil-producing province, is already looking for new industries that could eventually replace petroleum as the province's chief source of earnings. Other parts of the country will have to do the same as their particular natural resources are depleted.

There is another change occurring that could make it easier for us to adapt to the new situation – the changing shape of our labour force. In the 1960s and early 1970s the number of Canadians coming into the job market was growing very rapidly – a feature that can be traced back to the "baby boom" that followed the Second World War. With the economy growing too slowly in recent years to provide all the jobs required, unemployment has become a major problem. Governments have been particularly concerned about any measures that might reduce employment, even temporarily.

Already, however, the growth of our labour force has slowed down and by the 1980s the average annual increase will be only about three-fifths what it was in the early 1970s. We will be less concerned than now with simply expanding the number of jobs available. Concern will shift to providing more interesting and psychologically rewarding work for an increasingly better-educated labour force. In the long run, the knowledge and skill of our working population could provide a much more valuable and lasting resource and a better base for highly efficient industry than anything we have now.

Just as important as this changing economic background is the fact that Canada's political objectives are now approached in somewhat different terms. Nowadays fears about loss of independence are more likely to focus on the very high level of foreign – particularly American – ownership of our industry, and the flood of publications, broadcasting, and even social problems from south of the border. Canadians want to do their own thing. And, so far as national unity is concerned, attention is now focused on reducing the very considerable differences in income and wealth among the various regions and provinces, and with increasing the provincial say in national decisions.

Part II: The Benefits of Specialization and Trade

Before asking where Canada should go from here, let's go back for a moment to first principles. Why do countries trade at all? Why have governments been setting up trade barriers for hundreds of years? Would free trade (i.e., no trade barriers) be a good thing?

Why Trade Takes Place

Think for a moment about individuals. We specialize as mechanics, teachers, lawyers, doctors, carpenters, hockey players and so on. The reason – most are better at doing some things than others. By specializing we can become better still since we become more familiar with the tools and techniques of a particular trade. We can produce more and we can earn more.

But to specialize we must also be able to trade. If a doctor is to concentrate on providing medical care, he must be able to exchange his services for food, housing, car repairs and the many other things required for everyday life. Without trade, each of us would have to try to become self-sufficient – as people did on the frontier. That type of living can offer attractions but it would mean a far lower standard of living than most Canadians have come to expect.

Countries too are better at producing (they can produce at lower cost) some things than others. Here are some of the reasons:

(a) Gifts of nature over which we have little or no control

Canada, for example, has extensive mineral deposits, large forested areas, and both land and climate suitable for the production of very good wheat.

(b) Other factors which we may be able to change

The size and, perhaps even more important, the education and skill-level of population.

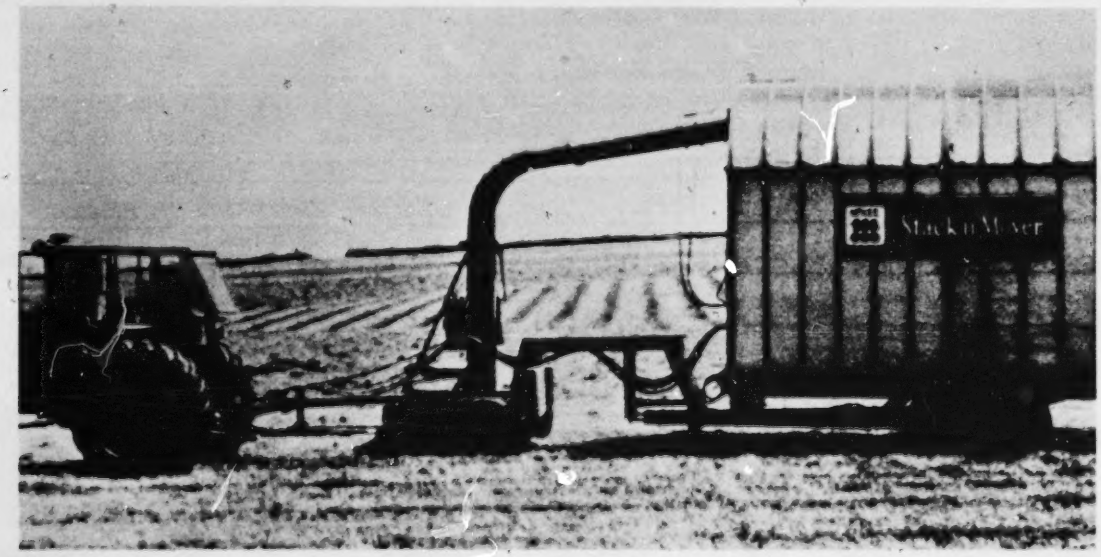
The availability of large quantities of machinery and equipment, things that take a good deal of time and effort to accumulate. Some goods require more of these things for their production than others.

Being first to develop and produce a new product, or to adopt new production techniques.

The ability to use mass production techniques. These techniques, however, also require markets of sufficient size to buy large quantities of the products concerned.

Differences among countries in factors like these can lead to trade. But, just which goods will be traded? For some goods this is easy to answer. Canada can produce wheat cheaply. On the other hand, our climate would make it very costly to produce coffee beans. The opposite is true for a tropical country like Guatemala. If Canada concentrates on wheat and Guatemala on

The "Stack n' Mover" haymaker made in Elmira, Ontario, was on show at the Baghdad International Trade Fair in October 1976 – as one example of Canadian manufacturing and engineering skill. Canadian exports to Iraq in 1976 were valued at about $36,000, and officials are working to increase Canadadian sales to all the newly-rich oil-producing countries.



Gains from Specialization and Trade with Absolute Advantage

Suppose that 1 unit of resources (i.e., land, labour and capital) can produce the following in Canada and Guatemala:

	Wheat (Bushels)		Coffee (lbs)
Canada	10	or	2
Guatemala	2	or	10
Total	12		12

Let's assume that each country has ten units of such resources available and that they split them equally (try some other split if you like) between wheat and coffee production. Each could then produce as follows:

	Wheat (Bushels)	Coffee (lbs)
Canada	50	10
Guatemala	10	50
Total	60	60

Now suppose that Canada moves 1 unit of resources out of coffee production and into wheat, and that Guatemala does the opposite. Production would then be:

	Wheat (Bushels)	Coffee (lbs)
Canada	60	8
Guatemala	8	60
Total	68	68

That is, there would be an increase in total production of both wheat and coffee. By specializing in this way and trading the excess over their own requirements, each could have more of both products.

Gains from Specialization and Trade with Comparative Advantage

Suppose that 1 unit of resources (i.e., land, labour and capital) can produce the following in Canada and the United States:

	Wheat (Bushels)		Newsprint (Tons)
Canada	10	or	1
United States	15	or	3
Total	25		4

Let's assume again that each country has 10 units of such resources available and that they split them equally between wheat and newsprint. Each could then produce as follows:

	Wheat (Bushels)	Newsprint (Tons)
Canada	50	5
United States	75	15
Total	125	20

Now suppose that Canada moves 2 units of resources out of newsprint production and into wheat, and that the United States moves 1 unit out of wheat and into newsprint. Production would then be as follows:

	Wheat (Bushels)	Newsprint (Tons)
Canada	70	3
United States	60	18
Total	130	21

Again, there would be an increase in total production of both products. And again, each country could have more of both products through increased specialization and trade.

coffee, both can gain by trading some of the product which each can produce best.*

In the foregoing example, Canada is said to have an *absolute* advantage in the production of wheat and Guatemala in coffee. But now we come to a point that at first may seem to be puzzling. *It is not necessary for such an absolute advantage to exist for trade to be profitable!* All that is required is that one country be *relatively* more efficient in the production of one commodity than another.

In this example, in terms of resources used, the United States produces both wheat and newsprint at less absolute cost than Canada. But it is three times more efficient in newsprint production and only one and a half times more efficient in wheat. In this case the United States is said to have a *comparative* advantage in the production of newsprint and Canada has a *comparative* advantage in the production of wheat. Each country could have more of both products by specializing to some extent and trading.

This proposition broadens the possibility of gains from international trade. And it holds even when the possibilities for trade in many more commodities and among many countries are considered.

** The question of how this gain may be shared is not covered in this paper. This is one of the issues noted in J.H. Perry's introduction.*

Canada specializes in health and gourmet foods and there is a keen market in the States.

Of course, modern industrial productions is much more complicated than the examples indicate. Many large corporations produce a wide range of products that may differ only slightly from each other. There are many varieties of cars, soft drinks, lipstick and so on. Advertising may condition us to demand more of one type than of another.

Strangely enough, this type of "imperfect competition" can further broaden the possibilities of gain from specialization and trade. By specializing in a few lines that differ only in minor ways from those produced by their competitors, firms can get longer production runs, and therefore lower their costs. Thus instead of one country's industry specializing in skis and trading some of those to another for shoes, you are more likely to find a ski industry and a shoe industry in both countries, each of which will import some types of skis and shoes and export others.

Comparative Advantage

Now look more specifically at Canada. By examining the pattern of our trade it is possible to say something about where our comparative advantages lie *under existing conditions*.

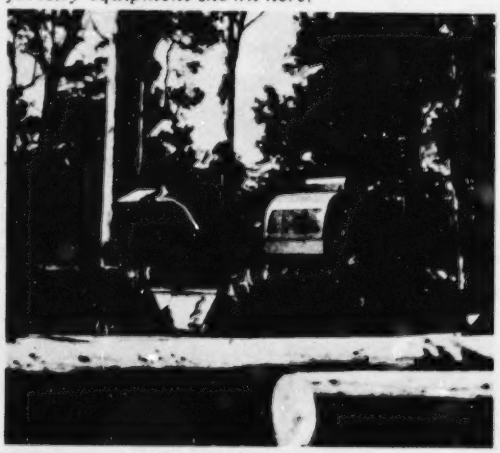
Canada's greatest comparative advantage at present is in natural resource products, and particularly the non-renewable products of our mining industries. This reflects both the abundance of those resources and the fact that we have been able to get hold of the large amounts of capital required for their development. In agriculture, we appear to have a comparative advantage in such commodities as wheat, barley and oats, but a disadvantage, for example, in manufactured dairy products, wool, lamb and mutton.

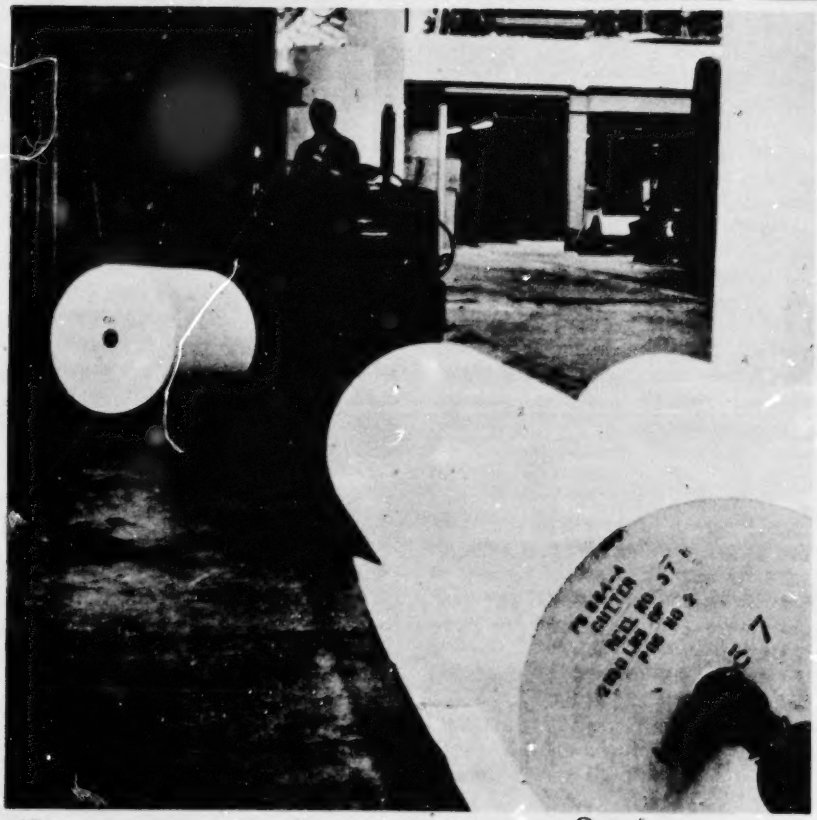
Exports of highly manufactured goods are, however, much smaller relative to total exports for Canada than for its major trading partners. Moreover, our imports of business and professional services, such as consulting, industrial designing and marketing research, are far greater than our exports. There is considerable variation among industries. But at this time our trading advantages are generally less and our disadvantages greater in these more advanced goods and services. Our greatest trade disadvantage is in industries that employ a lot of low-skill labour.

It is not hard to explain our difficulty in competing in industries that use unskilled labour. Canada does not have the abundant supplies of low-wage labour that are used so effectively in some overseas countries. But the weakness in other areas of manufacturing cannot be explained quite so easily. It does not seem to be explained by an unavailability of machinery and equipment. Canadian manufacturing tends to use about the same amount of machinery and equipment per worker as U.S. manufacturing and more than its Japanese counterparts. However, our supply of high school and university-trained labour – in particular, the supply of highly-trained managers – is not quite up to the levels of those countries. But the major difference seems to lie in the fact that many of our manufacturing industries use both capital and labour less efficiently than our trading partners; we require more of each to produce a given volume of output. This in turn seems to be related to trade barriers that confine our manufacturers to a small home market and make it more difficult for them to specialize.

With our present level of knowledge it is difficult to pick the products or even the industries in which Canada's comparative advantage will lie in the future. No doubt we will continue to depend upon our natural resource base a good deal, but at least some of those resources will be less abundant. As for labour, total supply will grow more slowly than it has in the past. But the supply of more highly-educated labour will increase relative to total,

There is an expanding market in Australia and New Zealand for the sort of Canadian manufactured forestry equipment shown here.





because of Canada's large expenditures on education in the 1960s and 1970s.

Thus it is difficult to see Canada expanding production of goods using a lot of relatively unskilled labour. One area of considerable promise is the combination of our more educated labour force with the accumulated knowledge of our resource industries – for example, the manufacture of machinery for use in mining or forest industries. Canadians have also accumulated a great deal of knowledge in some service industries including education, health and finance (for example, banking and insurance). Here too the greater availability of highly educated labour will be of help.

Some people claim that trade barriers determine, in large part, our comparative advantage. They argue that the removal of trade barriers would enable Canada to specialize more fully in the goods we produce best.* Intensive analysis of industries and commodities could help to point up some of the more promising areas. But exactly which goods would be exported or imported would depend on Canadian wages and the foreign exchange value of our dollar. These, in turn, would be affected by the removal of trade barriers. Many supporters of free trade would argue that government should concentrate on providing a framework of stability for business decisions. They believe that businessmen, given a stable framework, are far better than the government at judging the best trade prospects.

Interference with Specialization and Trade

Trade barriers raise prices to consumers. They also tend to direct our productive resources away from the things we do best and into making items that could be bought more cheaply elsewhere; we produce less and our national income is lower. So why not just get rid of all trade barriers and move to free trade?

Part of the reason may be that economists have just not been able to get their message across. Then too, tariffs and other trade barriers favour particular groups of producers, including particular groups of workers, and these are usually better organized than consumers. But the problem goes much deeper. There are some very good arguments for interfering with specialization and trade. The problem is to decide just how valid they may be for a particular country at a particular time.

Any general economics textbook can provide you with all sorts of arguments that have been used to justify protection. One is that trade barriers are needed to protect our workers against low-wage foreign labour. Suppose we import a lot of, say, textile products that are produced by Asian labour at wages only one-fifth or one-tenth those in Canada. Our wages, it is argued, will be driven down and our standard of living will fall.

As consumers we are better of if we can obtain a product of equal quality from the Philippines, for example, but at half the cost of one produced at home. But most of us can't be consumers unless we work. So what happens to the workers? Well, we showed earlier that even when one country produces everything at lower absolute cost than another there can still be gains from trade. What might be expected to occur is that over a period of time Canadian production and employment would shift away from these textile products to something in which we have a comparative advantage. Then Canada and the Philippines would both be better off. But note the deliberate use of the term "over a period of time". Therein lies a problem to which we will return shortly: shifting workers and equipment into new lines of production involves costs.

Another group of arguments revolves around the objectives of national policies. Specialization and freer trade may bring greater efficiency and higher output but those are not the only objectives a country may wish to pursue.

Some people would claim, for example, that too much specialization could lead to dull, boring jobs. Or, there is the fact that many Canadians have been prepared to accept an economic cost (a lower standard of

For example, greater specialization by Canadian automobile manufactures after the Canada-U.S. Automotive Agreement came into effect in 1965 brought a 90 per cent increase in efficiency of their assembly operations.

living) because they felt tariffs contributed to national independence. Trade barriers may also be used quite deliberately to give certain groups more income. Countries may protect certain industries too because they are considered vital for national defence.

The desire for security can take other forms as well. Specialization in a small number of products may leave a country too dependent on a small number of markets. Wide price fluctuations in just a few markets or quick shifts in tastes could cause much disruption. You may be the world's largest and most efficient producer of skateboards this year. But if the demand for them dies out next year, you could be in real trouble.

Protection may also be aimed at increasing output and efficiency – but over long periods of time. The "infant-industry" argument suggests that given time, some industries may eventually become very efficient, perhaps by developing economies of mass production. Protection could be used in their early stages to gain them a start free from foreign competition.

In recent years, however, one argument stands out above all others. Canadian industry has grown up under the effects of protection here and in other countries. It may be that some of our industries have been too heavily protected and perhaps we are not always producing in line with Canada's comparative advantage. But the removal of trade barriers would mean moving to a new industrial structure. Such a change would involve costs – including unemployment in some industries and regions or heavy new investment in others.

Economists have argued that freer trade will bring great benefits "in the long run". But benefits for the country as a whole 10 or 20 years from now may mean very little to the people who fear that they may lose their jobs or their plants in the process of adjusting to freer trade.

The problem is not all black or white. For a particular country at a particular point in time it comes down to asking these questions:

> What is the objective of the policy in question? Does the policy really contribute to that objective? If it does, is it the least costly way of achieving that objective? What are the benefits and costs? Who pays?

Australia's "Endeavour", seen here in Sydney Harbour, frequently plies its course between the South Seas and Saint John, New Brunswick. From Australia and New Zealand, this ship and others like it bring meat, canned fruit and wool. They take back fish, potash asbestos, auto parts, aluminum ingots and newsprint.

Part III: A Trade Policy for Canada

Trade liberalization is not new to Canada; we have been committed to such a policy for years. But now the issue is whether or not we should try to speed up the removal of trade barriers. How far and how fast should we move towards complete free trade?

In recommending more rapid trade liberalization in a report issued July 1975, the Economic Council of Canada concluded:

> "*... a free trade policy is not only feasible for Canada but is the best guarantee of its national objectives.*"

Now that you are aware of some of the sensitivities surrounding Canada's commercial policy, you will not be surprised to learn that this conclusion generated intense debate in some quarters.

The discussions have shown that there is a good deal of agreement on several points. Canada faces serious problems of productivity and international competitiveness, particularly in our manufacturing industries. The small size of the Canadian market has a good deal to do with this, although opinions vary about its importance relative to other factors. Finally, because of the changing nature of the world economy, these problems will grow worse unless some action is taken. At that point agreement stops.

Trade Liberalization Versus Domestic Measures

Two broad approaches have been suggested as solutions to Canada's productivity problem: (1) trade liberalization and (2) domestic measures. Both start from the assumption that for many products the Canadian market is too small to support a large number of producers and product lines at world competitive prices. The domestic measures suggested include tax incentives and loans to promote investment and research and development, arrangements to improve labour relations and collective bargaining, and purchasing arrangements by federal and provincial governments that would favour Canadian manufacturers. Most important, they include proposals to encourage reorganization of Canadian industry on the basis of the domestic market alone. For example, instead of having ten firms serving the Canadian market with a wide variety of refrigerators, we might encourage some of them to merge and specialize. Eventually we might have two or three – or perhaps even one – each producing fewer lines and thereby achieving lower costs.

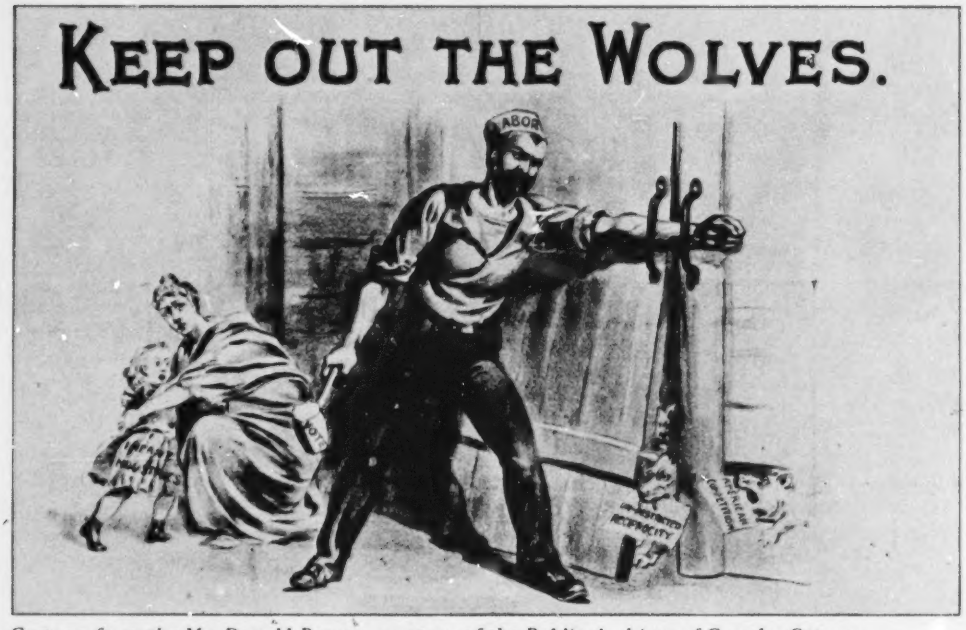
There is no reason why at least some of the domestic proposals could not be used along with trade liberalization. But let's compare domestic measures with free trade in terms of the questions set out in the previous section. Both are aimed at the same objective – increasing economic efficiency. Domestic measures have the advantage that Canada can undertake them for the most part without lengthy international negotiations (a benefit). And they do not get us into questions of political independence that come up under trade liberalization (a benefit). They are, however, likely over the long run to involve greater government intervention in the economy (perhaps a cost – it depends upon your political philosophy)*. For example, "rationalization" through domestic policies could be expected to lead to larger firms with lower production costs. In that case, governments might well have to regulate those firms to make sure that the savings were passed on to consumers (as is done now in areas like transportation and communications). Under free trade, international competition could force firms to pass on savings.

Critics of the domestic approach argue, too, that it would not provide anything like the economic benefits that could come from trade liberalization. They say that only very large international markets would be sufficient to bring about the specialization that Canadian industry requires.

Economic Costs and Benefits of Trade Liberalization

What about the benefits and costs of trade liberalization itself? Let's look first at the economic issues and then the political and social side.

* *Both the trade liberalization and domestic approaches would involve some forms of government intervention in the short run to assist or induce industries to reorganize.*



Cartoon from the MacDonald Papers; courtesy of the Public Archives of Canada, Ottawa

First, what is meant by free trade? Various free trade arrangements will be examined later. For the time being, we are talking about the large-scale reduction or removal of tariffs by all countries as well as the elimination of non-tariff barriers by all countries that have them. The impact of *multilateral* free trade would be quite different from that of unilateral free trade (removal of Canadian trade barriers only).

Second, we must distinguish between the immediate impact of free trade and its effects over a longer time period. To achieve long-run benefits Canadian manufacturing would have to reorganize towards longer and more specialized production runs. So you must ask what the impact of free trade would be:

(a) *before* industry had a chance to reorganize, and
(b) *during* that reorganization.

Opponents of free trade have two major criticisms for a start. First, they suggest that the costs or removing our trade barriers would be very large, particularly in terms of unemployment. Second, they claim that whole Canadian manufacturing industries would go out of business; Canada would be left largely as a producer of natural-resource products. We would be "hewers of wood and drawers of water".

Effects of Free Trade on Employment and Industrial Efficiency

Supporters of trade liberalization claim that many of the fears of free trade – particularly those about large-scale unemployment – are based on expectations of what might happen during the first of the stages above. They point out too that only 20 per cent of total Canadian employment is now in manufacturing, the sector that would feel the greatest impact from trade liberalization. Still, 20 per cent in this case amounts to over 2 million people. Any sharp increase in unemployment of that many people would certainly have drastic effects.

The Economic Council examined the effects of free trade on employment under these "no reorganization" circumstances. Its research suggested that the impact would not be nearly so great as many feared – that unemployment was not likely to increase by more than 1 percentage point or so even under complete tariff-free trade. It suggested too that other policies could be used to prevent even this increase.

Even if you agree with this conclusion (and some don't), it still answers only part of the problem. Would Canadian industry be able to reorganize so as to become internationally competitive? How would

this take place? Since *present* costs in many Canadian manufacturing industries are higher than those of their foreign competitors, would our industries not be driven out of business if their protection were removed?

Now you really have to keep your eye on the ball. The right question to ask is this: Would present costs remain the same if our own *and* foreign trade barriers were removed? The answer: some would, some would not!

Some of the present costs of Canadian manufacturing are related to our own and foreign trade barriers. Some machinery, for example, costs more in Canada simply because of our own tariffs. With that tariff removed across a broad range of manufacturing industries, the prices of such items would fall. More important; if our manufacturers could penetrate large foreign markets (if foreign trade barriers were removed) they could cut costs again through longer and more specialized production runs. And we have already mentioned that the nature of modern industry encourages specialization and trade in narrower product lines.

But just what incentive would Canadian firms have to go ahead with such specialization? All we have said so far is that it would be possible to get one group of costs down to internationally competitive levels, Now we must ask if production locations in Canada provide any advantages over foreign competitors with respect to costs that are not directly related to protection such as those of wages, borrowed capital, raw materials and transportation.

Many of our competitors are located in the United States. Generally speaking, Canadian firms do not have any advantages over firms located in the U.S. because of capital and raw material costs. Whether or not they have advantages with respect to transport charges will depend upon just where they and their competitors are located. It is well to remember, however, that some Canadian locations are very close to major U.S. markets.

A Canadian firm in Toronto, for example, might be able to sell into the New York market more cheaply than a U.S. competitor located in Minneapolis.

What about wage costs? A few years ago wages in Canadian manufacturing were generally below those of their main U.S. competitors. Now they have in many cases reached or exceeded U.S. levels and they are considerably higher than wages in Asian or European countries. This removes one major attraction to locating a manufac-

Canada exports sportswear in the medium to high-priced bracket, to Sweden. Clothing was one of the industries which benefited from the General Adjustment Assistance Board, set up in 1968. The Board helped Canadian businesses to take advantage of opportunities arising out of the Kennedy Round Tariff and Trade Agreements in Geneva (1967-72).

GAAB (now "Enterprise Development Program") guarantees sizeable working capital loans to Canadian companies, such as clothing and electronics, which are struggling to maintain their competitive position in both the national and international markets when tariffs are lowered.

turing plant in Canada, at least for the time being. However, under the present circumstances free trade would initially cause Canada's imports to increase faster than its exports. In turn, this change would encourage the foreign exchange value of the Canadian dollar to fall, because there would be less demand for Canadian dollars. With a lower exchange rate, Canadian-made goods would become cheaper to buyers from other countries, and this would help to restore the advantages of Canadian locations.

Supporters of free trade contend, on the basis of the analysis above, that many Canadian manufacturers would be able to compete internationally, given freer access to foreign markets. Removal of trade barriers would not generally mean that whole industries would be put out of business. In most cases there would be a shift to more specialized lines of production within existing industries and firms. This is exactly what happened in Europe when France, Germany, Italy, Belgium, Luxembourg and the Netherlands agreed to remove trade barriers amongst themselves and form the European Economic Community.

Notwithstanding this example, some Canadian manufacturing industries would be hurt. Many industries would see substantial cost savings from longer and more specialized production runs. But some of the industries that use a lot of labour, such as clothing and textiles, would suffer because of Canada's relatively high labour costs. The cost of labour to produce a Hong Kong shirt is considerably less than the cost of labour to produce a Canadian one. If Canada imported all the Hong Kong shirts that Canadians would buy, the Canadian textile industries would suffer. And some of them provide the main source of income in certain communities in Canada.

For other Canadian industries prospects could be much brighter. The steel industry, for example, does not face this degree of competition from less developed countries. And it is already so efficient it could probably adjust to free trade with little difficulty. Still others would be able to make the change but only after incurring considerably greater costs for new equipment, moving to new locations, and setting up selling and distribution networks in other countries.

Some of these changes are likely to be forced on us no matter what trade policy Canada follows. Freetrade would only speed them up. Consequently, there is fairly general agreement that Canada must improve government programs to assist

The Canadian steel industry has developed internationally competitive operations, based on Canada's natural resources and the most advanced technology available to the industry. Shown here is Stelco's Griffith Mine in northwestern Ontario.

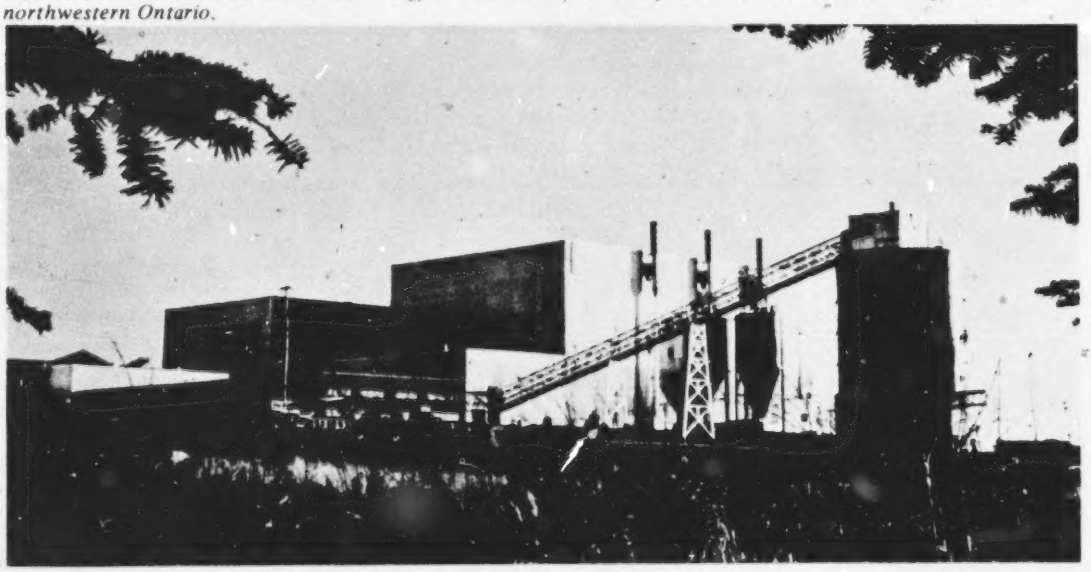


photo: Courtesy of the Steel Company of Canada Limited

industry in adapting to change. Nearly half of the Economic Council's recommendations for a new trade policy focused on just such measures. Recommended policies included government spending on employment and more specific programs to help particular firms to move into new product lines, to retrain workers and managers, and to plan and finance area redevelopment.

Other Economic Concerns

Increases in industrial efficiency and national income are not, as we noted earlier, the only policy objectives a country may puruse. Let's look briefly at some other issues that have come up in the free trade debate.

Take the matter of regional development. The debate has shown that support for free trade is still much stronger in the Atlantic and western provinces than in Ontario and Quebec. Strangely enough though, supporters of free trade now argue that Ontario and Quebec, with by far the largest proportion of Canadian manufacturing, would stand to get the greatest benefits *in the long run*. The catch is that they would have to undergo greater adjustments to achieve those benefits. The Atlantic and western provinces, and particularly British Columbia, would all gain, the argument goes, though somewhat less than the central provinces. On the other hand, they would face far less adjustment, largely because they depend much more on natural resource industries. What this means is that free trade, of itself, would not reduce the gaps in income and wealth that now exist among the provinces. If it provided us with a higher national income, however, some of that might be used to promote the development of the poorer regions.

Critics have also suggested that free trade could lead to increased foreign ownership of our industry. The quickest way for many Canadian firms to penetrate the U.S. market, for example, would be to join with U.S. firms. Free trade supporters agree that this is a strong possibility. But they contend that their approach would provide expanded opportunities for Canadian firms. These opportunities could result in higher national income and more funds for investment. In time we could afford to buy back firms now owned by foreigners, or expand Canadian holdings in other countries.

Political and Social Considerations

Questions like those of regional balance and the level of foreign ownership are linked to a much broader set of political and social issues – issues that are even more complex than the economic ones.

Much of the debate on free trade continues to centre on its implications for national independence, especially independence from the United States. The Economic Council study concluded that free trade with many countries was ideal. But it added that whatever free trade arrangements might be considered, they must include the United Stat

One member of Parliament has termed the suggestion of free trade with the United States "national suicide". The Montreal Gazette in an editorial said that it would mean handing this country to the United States "on a platter".

Such criticisms are based on several concerns. There is fear, first of all, that free trade would make Canada more vulnerable to policies adopted by the United States in pursuit of its own national objectives. Another potential problem is that under free trade various Canadian and U.S. policies, for example, tax policies, would have to be co-ordinated much more closely than at present. There is a fear that with the United States so much bigger than Canada, the American view would always predominate. Most of all, there is a fear that Canada-U.S. free trade would ultimately lead to Canada being absorbed politically by the United States.

Supporters of free trade counter with the suggestion that Canada and the United States are already very interdependent. They feel it would be better to have the ground rules for such interdependence agreed upon in a formal treaty. They bring up evidence too that free trade arrangements do not inevitably lead to political union. Great Britain and the Republic of Ireland have had a free trade arrangement for a long time. There is not much evidence that the Irish wish to join again in a political union with the British.

In the social and cultural areas the problems are still more complicated. Here the question is whether or not a freer flow

of goods between Canada and the United States in particular would create even more opportunities than at present for transmission of U.S. ideas, lifestyles and even social problems to this country. Free trade supporters argue that if Canada wants to promote cultural independence, it should do so by more direct means than the tariff.

Possible Routes to Free Trade

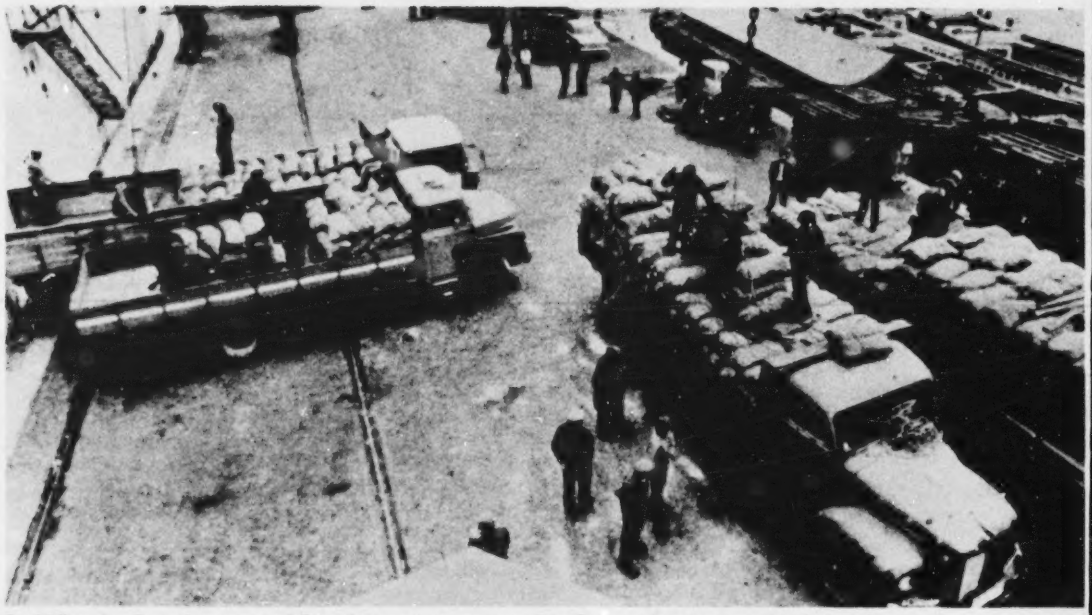
There is strong support for the position that Canada's industrial structure will require some reorganization to achieve international competitiveness under rapidly changing conditions. It is also argued that multilateral free trade agreements will have to be an important ement in this process. Much of the discussion today concerns the various routes that we might follow to achieve this goal in a reasonably short time.

The route now ahead of us involves multilateral trade negotiations under GATT – and Canada will be participating actively in this procedure in 1977 and 1978. Unfortunately these negotiations are slower and more difficult now than they were a few years ago. Not only do they have to deal with a hard core of remaining tariffs but they are also concerned with the much more difficult task of regulating or eliminating non-tariff barriers to trade. Some non-tariff barriers are very difficult even to identify; others, like health and safety standards, will require a great deal of international negotiation if they are to be standardized.

A number of procedures for reducing tariffs have been suggested for the present trade negotiations. One is to reduce all high tariffs to a common ceiling and to cut the not-so-high tariffs by some agreed percentage. Another is an equal percentage cut in all tariffs with a minimum of exceptions.

A cartoon inspired by the third in the series of economic summit meetings, after Rambouillet and Puerto Rico, held in London, May 1977; courtesy of the Toronto Globe & Mail

'Two hotels and a nuclear silo. Y'all owe me fo' hundred dollars.'



In 1976, the first shipment of Canadian potatoes arrived in Portugal and was unloaded at Santa Apalonia Dock in Lisbon. Previously, the Portuguese authorities prohibited Canadian potatoes on "phytosanitary" grounds, but when Portugal and the rest of Europe had a bad crop the regulation changed.

This approach Canada finds difficult to follow.*

Recognizing this country's difficulties with such general tariff-cutting formulas, as well as the necessity of doing something about non-tariff barriers, the Canadian government has proposed a "sectoral" approach. Under this approach the attempt is made to remove all trade barriers among certain industrial sectors rather than for all commodities. For example, our delegation would propose the removal of tariffs and non-tariff barriers on all copper products from the raw material stage to at least partly manufactured industrial materials. This ties in with the government's attempt to promote more advanced processing of our natural resources. The problem is that various countries' ideas on which sectors they wish to negotiate are quite different. It could become very difficult to balance off concessions that we might make on, say, aero-space equipment with others' concessions on copper products.

* *An equal percentage cut in our own foreign tariffs would give the industries of other countries much better access to Canadian markets. But they would not necessarily provide sufficient incentive for the reorganization required here if Canadian manufacturers are to compete abroad.*

The Economic Council has suggested that if progress in the multilateral tariff negotiations is not sufficiently rapid Canada should consider other routes – still within the provisions of GATT – that would accelerate the process. These could include possible free trade arrangements with smaller groups, particularly the European Community, Japan and the United States. If the Community and Japan are not interested however – and they have given no indication that they are – we come back again to the long-standing Canadian dilemma concerning any arrangement with the United States alone.

One other suggestion has been that Canada could improve its present position by simply dropping its trade barriers regardless of what other countries do (unilateral free trade). As a step towards an ultimate goal of multilateral free trade, such a move would be questionable. It would involve far more disruption of our economy. It might even destroy some industries that could well survive if other countries' trade barriers were eventually removed. And it would reduce this country's bargaining power in future negotiations.

The course that Canada will actually follow is not by any means under its own control. It will depend upon a great number

of economic and political considerations, some of which are subject to change. If economic activity in the major trading nations slows down and unemployment rises – as seems to be taking place early in 1977 – negotiators will be more reluctant to press for rapid reductions of trade barriers. And there will be resistance to change simply because there have already been such marked shifts in trade patterns and exchange rates in recent years. There are questions too about the policies and attitudes of other countries. Even if Canadians could solve the political problem connected with any proposal of Canada-U.S. free trade, would the United States be interested?

Whatever the desirability of multilateral free trade, it must be recognized that such factors could have a bearing on the pace at which it can be achieved. What is important, however, is that Canadians must not simply react to the suggestions of other countries. They must set their own priorities so that they are in a position to respond quickly to the opportunities and the challenges that are emerging.